



LP LABORATORIES LTD.: FINANCING WORKING CAPITAL

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Professor Jayadev M, Professor of Finance and Accounting, prepared this case for class discussion. This case is not intended to serve as an endorsement, source of primary data, or to show effective or inefficient handling of decision or business processes.

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LP Laboratories Ltd.: Financing Working Capital



In the second week of July 2013; Andheri (East), the Mumbai branch of Kendriya Bank of India Ltd. (KBIL) received a request from LP Laboratories Ltd. (LPL) for enhancement and renewal of various bank financing facilities, the last such renewal was done 15 months earlier. LP Laboratories has been associated with KBIL since 1990 for its fund and non-fund-based finance requirements, owing to the enhanced business activity of LPL, the quantum of financing requirements increased and in addition to KBIL a consortium of four banks were providing the finance. KBIL was the consortium leader with 48% share. KBIL has been a large commercial bank in India and specifically the Andheri (East) branch was dealing with corporate banking. Prasad, Senior Manager (Credit) was going through the credit file and the renewal request.

LP LABORATORIES

LP Laboratories was promoted by B. K. Gupta in 1988; its main business activity was the manufacture and export of bulk drugs, pharmaceutical formulations, injectables, and fine chemicals. LPL was set up originally as a proprietary unit, converted into a private limited company in 1992, and subsequently became a public company in 2002. The company had three plants located at Ankleshwar, Mandideep, and Aurangabad. Gupta's family was the single largest shareholding group in the company with a holding of 60% and actively involved in management of the company. B. K. Gupta was the Chairman and Managing Director and his wife was the executive director, daughter and son were also part of the top management team and board members. Among the two independent directors, one of them was an accounting professor from a reputed business school of North America. LIC of India that provided a term loan was also nominated a director on the board of the company, being indirectly interested to the extent of mortgages and charges created in favor of LIC.

The company pioneered the manufacture of ethambutol hydrochloride, an anti-tuberculosis drug in India from the basic stage and in 2015, about 47% of the company's turnover comprised anti-TB drugs. By the end of the year, bulk drugs comprised 44% of the turnover, but reported Rs. 20 million (\$1 = Rs. 67, August 26, 2016) loss. Bulk drugs or active pharmaceutical ingredients (APIs) are basically the active raw materials used in a drug that renders it the therapeutic effect. The annual report for the year 2012-2013 also states that the bulk drug business was under pressure from over capacities and turbulence in the South-East Asian markets.

The company's strategy involved shifting the emphasis within bulk drugs from low margin-high volume growth to high margin products. The company intended to leverage the strengths of the bulk drugs segment integrating the supply chain for formulations. Generally, pharma companies have the liberty to "formulate" the bulk drug using excipients of their choice depending on chemical feasibility and commercial interests. The medicines available in the markets in the "form" of tablets, capsules, syrups, drops, intravenous fluids etc., are therefore "formulations".

In order to reduce its dependence on the anti-TB range of drugs, the company planned to launch products in areas such as ophthalmology, gynecology, neurotropic, and diabetes.

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The focused areas of LPL's growth articulated by the Chairman are as follows.

- Focus products where the market is – United States, Europe, and Japan.
- Develop a fully integrated position of strength for the generic product markets globally, especially for Cephalosporins.
- Develop products well ahead of patent expiry with non-infringing processes, stabilized quality, and cost.
- Focus on anti-infective and cardio-vascular which together constitute 60% of the global pharmaceutical market.
- Focus on photo-chemistry and unique drug delivery systems.

The company launched a very ambitious plan of expansion and diversification of its product range with joint ventures and creation of additional manufacturing facilities at the existing units. The major projects undertaken by LPL are as follows.

- Setting up a joint venture (JV) for manufacture of some formulations in the United States, by sourcing the bulk drugs from LPL India. The total investment required by the JV for the acquisition of such facility was estimated to be around US \$32 million, of which LPL's investment was estimated at US \$ 6 million.
- Strategic alliance with Merck Generics for marketing LPL's injectable products.
- JVs in Africa and Russia for anti-TB drugs were in the advanced stage of commencing business operations.
- Five new bulk drugs were proposed to be launched that year. For the purpose of manufacturing facilities and other capital expenditure, the company had already received sanction from Industrial Finance Corporation of India (IFCI) for term loan/NCD facilities of Rs. 900 million. IFCI has been the leading financial institution of India and generally provides long-term debt finance

LPL had a marketing and distribution network of over 800 medical representatives, 21 sales depots, and a distributor network of 1,500 stockists. LPL formed JVs with local partners in Thailand, South Africa, and Russia. These were set up mainly to market LPL's anti-TB drugs. LPL had also entered into a 50–50 JV with the Puerto Rican firm, MOVA Pharmaceutical Corporation of the United States for \$90 million. LPL Holdings, Luxembourg, the wholly owned subsidiary of LPL entered into a JV with MOVA. The company was also very alert in its market research and did not let off any opportunity arising out of formulations/bulk drugs going off-patent.

BANK FINANCE

Banks provide working capital finance both at pre- and post-sales. At the pre-sales stage, a firm requires finance to invest in current assets – purchasing raw material inventory and for meeting other operating expenses. Based on the firm's competitive position and credibility in the market, a firm may avail credit from suppliers for purchases and balance amount of current assets are funded either out of its own equity or borrowing from banks. A few companies enjoying competitive market position can finance entire

current assets through supplier's credit, that is, current liabilities only and may maintain zero or negative working capital, for example Bajaj Auto, Hindustan Unilever, and ITC among others. Other well-rated and highly credible firms can avail the required loan amount (current assets minus current liabilities) from bank finance, or by following a conservative financial policy a firm may take limited loan amount or may even go for zero-debt bank finance. In such an instance, the firm's equity is financing the current assets. Once the sales are made, banks provide working capital finance against the receivables. Working capital finance is structured and delivered as different products such as loan component, cash credit, and so on (see **Annexure I** for details). Mostly, credit sale transactions are routed through bills of exchange; banks have been providing financing facilities such as bills discounting and bills purchased. The mechanism of bills of exchange is presented in **Annexure II**.

The bank's (KBIL) loan policy emphasizes on three different models for financing working capital requirements of business firms. For all manufacturing entities, the bank follows balance sheet gap method, where the gap between current assets and current liabilities was financed. The bank also expects the firm (borrower) to contribute a portion of current assets out of equity, that is, long-term stable source of finance. The bank evaluates the requirement of current assets on the basis of holding levels and credit payment periods (operating cycle) and suggests the norms, broadly on the basis of industry averages (**Exhibit 2**).

The loan policy states that the firm's contribution should be at least 25% of current assets and managers have discretionary powers to relax this norm on case-to-case basis. The other two models are assessing working capital requirements as a percentage of sales for trading entities and financing the difference between cash inflows and cash outflows; known as cash gap method for service sector enterprises.

LPL's FUNDING REQUEST

LPL has been availing various forms of working capital finance such as cash credit, bill discounting, and credit for exports from the KBIL and as at the end of March 2013, the outstanding loan facilities with KBIL and with other consortium member banks are presented in **Exhibits 1** and **8**. The cash credit (or overdraft) facility was being availed from other branches of KBIL, summary transactions are provided in **Exhibit 6**. During February 2013, the company approached the bank for an additional working capital loan of Rs.100 million (\$1 = Rs. 67, August 26, 2016) to meet the demand arising out of increased sales; as the account renewal was due, the bank has sanctioned this amount as an *ad hoc* limit.

The working capital loan was backed by primary security over current assets; all the consortium members had "*paripassu*" (equal right on the current assets) rights. Furthermore, two promoter directors of LPL had provided personal guarantee of Rs. 1,105 million exclusively to KBIL.

The current proposal is for enhancement of consortium fund limits from Rs. 1,705 million to Rs. 2,200 million and non-fund based limits from Rs. 920 million to Rs. 1,150 million for the next year 2013-2014.

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In the bill portfolio, there were neither unpaid bills nor overdue bills. However, the record shows that LCs have been devolving on banks which were being cleared within a period of 10 to 15 days. In 2015, the company was availing an inland/import D/P LC limit of Rs. 720 million (90 days for inland, 180 days for import). The company had requested for increasing LC limit to Rs. 900 million with a provision that the entire LC limit should be allowed as DP/DA (up to 180 days) facility. The total purchases projected by the company are worth Rs. 1,400 million. The maximum utilization of EBP/EBD under LCs during 2015 from all the consortium banks was around Rs. 100 million.

LPL planned to raise resources through the GDR route, but owing to certain adverse developments, the company altered its plans and raised the resources from domestic sources. LPL requested for the conversion of working capital demand loan (WC DL) into a foreign currency loan instead of Rupee loan.

LPL had an export order worth Rs. 252.23 million and the bank sanctioned Rs. 113.5 million as cash credit cum packing credit facility. The company requested the bank to convert this packing credit facility into a running account facility, which Prasad had to recommend to the higher authorities.

The company also requested for an increase in the bank guarantee limit from Rs. 2,000 million to Rs. 3,000 million in view of increased level of overall operations. Bank guarantees are required for clearance of imported raw materials under concessional duties of local and state government authorities such as excise department and octroi. LPL also requested for issue of bid bonds.

BANKER'S DILEMMA

Prasad went through the entire file in addition to the financial statements, other production data, and also several observations made by the corporate banking officials on different occasions. The accepted level of inventory norms at the time of last assessment of working capital requirements is provided in **Exhibit 2** and the financial statements of both past and projected are presented in **Exhibits 3, 4 and 5**.

Prasad also requested his manager for a summary of current account transactions of LPL for the last one year (**Exhibit 6**). In addition to fully utilizing the sanctioned limits, LPL requested *ad hoc* (temporary) loan facilities occasionally; this resulted in excess drawings in cash credit account (CC) and in export bills/packing credit account. The last one-year record showed that the additional loans provided on temporary/*ad hoc* basis, loan allowed in CC account was to the tune of Rs. 27.03 million; Rs. 29.94 million in EBP account and Rs. 33.91 million in PC account.

A few months earlier, the bank had ordered special audit by a leading audit firm and stock inspection by another valuation firm, both the reports indicated that LPL was dealing with banks other than the consortium members. Similarly, the reports pointed out that additional attention was needed over investments in group companies. Other irregularities were also noticed in stock valuation.

In the last consortium meeting, the company was advised to take an insurance policy against the collection risk of export receivables from export credit guarantee corporation (ECGC). The company had not adhered to this advice, and for the present loan proposal, the company requested a waiver of the

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clause on buying ECGC insurance coverage. During the current year and in the previous year, the company had not been able to make repayment of term loans as per the original repayment schedule. The company had obtained a term loan from LIC of India (LIC) and requested for rescheduling a debt of Rs. 1260.5 million.

Financial statements of the company showed non-current assets (loans and advances) including deposits given by the company against residential premises of executives worth Rs. 267 million and advances to field staff for meeting travelling and other incidental expenses of Rs. 203 million. LPL requested the bank to consider these as a part of current assets; these were purely of temporary nature and had to be ploughed back into the system within a year. For the last few years, the company has been mobilizing large amounts of fixed deposits and inter-corporate deposits and the company was willing to maintain this level. LPL requested the banker to consider this as non-current liabilities for the purpose of working capital (WC) assessment. The company also informed that the preference shares were due for redemption.

The auditor's qualifications of the annual report indicated that the company had given a guarantee on behalf of Poly Industries worth Rs. 95.09 million and Rs. 79.62 million on behalf of M/S LP Chemicals Ltd. LPL had invested Rs.17 million in equity shares of Poly Industries. Poly Industries' financial soundness had not been well in the last few years and being an unlisted company, financial and other corporate disclosures were very limited. LPL stated in its accounting notes that, in view of its long-term involvement in these companies, no provision has been made for probable losses. LPL had 20 associate/group companies; out of those tangible net worth of five companies was negative and 18 companies had availed credit facilities from KBIL.

The auditor's qualifications also stated that the company had disputed sales and an income tax liability of Rs. 29.5 million.

Prasad has to prepare a note to his Vice-President regarding the company's request for enhancement and renewal of various lending facilities. The note also had to include recommended loan covenants or terms and conditions.

Exhibit 1

Outstanding Financing Facilities of LPL Ltd as on March 31, 2013

Loan facilities	Sanctioned Limit by KBIL (Rs. in millions)	Outstanding Balance with KBIL (Rs. in millions)	Total Consortium Limits (Rs. in millions)
Cash Credit cum Packing Credit (CC cum PC)	1135	1156	3511.69
Working Capital Demand Loan (WC DL)	4530	4530	9157.03
Advance against Export Bills	0	86.47	0
Rupee Loan*	0	00	0
EBP/EBD against order	2520	1318	4518.21
EBP/EBD against Letter of Credit (LC)	No limit	899.19	0
Letter of Credit (DP)	3456	250	7436
Letter of Credit (DA)	2880	2915	
Letter of Guarantees	960	238	1764.00

*Other consortium member has sanctioned Rupee Loan of Rs. 500 million, hence not reported to KBIL

Source: Information submitted by the company to the bank

Exhibit 2

Inventory Norms

Component	Suggested by Bank (months)	Industry Aggregates (in days)
Raw Material Consumption (Imported)	2.00	68
Raw Material Consumption (Indigenous)	2.93	
Work in Process	1.30	19
Finished Goods	1.50	39
Domestic Receivables	2.69	66
Export Receivables	2.80	
Creditors	1.57	68

Source: Bank records

Exhibit 3 LP Laboratories – Financial Statements (Rs. in millions)

Particulars	2010-11 (Audited)	2011-12 (Audited)	2012-13 (Audited)	2013-14 (Projections)
LIABILITIES				
Share capital				
Ordinary share capital	2423	2423	3109	3109
Preference share capital	0	0	75	75
	2423	2423	3184	3184
Reserves and Surplus				
General reserve (including surplus in P/L A/C)	5105	5439	5832	5832
Other reserves	13480	11943	11879	12149
Investment allowance	0	0	0	0
Development allowance	0	321	270	0
Capital reserve	0	0	0	0
Surplus or Deficit P&L ac	320	1170	3479	7560
	18905	18873	21460	25541
Long-Term Liabilities				
Debentures bonds (not maturing within one year)	14504	11689	4020	12204
New Debentures	0	0	0	4711
Term loans (excluding installments payable within 1 year)	800	3743	2836	1331
New Term Loans	0	0	0	9633
Deferred payment credit	36	15	8	0
Term Loans (unsecured)	8239	1079	1208	4200
Term deposits (repayable after 1 year)	0	1755	2569	3875
Corporate fixed deposits	0	1594	3125	3125
Other term liabilities	0	0	0	0
Total Long-Term Liabilities	23579	19875	13766	39079
Current Liabilities				
Short-Term Borrowings from Banks				
From Kendriya Bank India Ltd. (KBIL)	4868	5484	8972	8185
From other banks	3157	6485	9333	13815
	8025	11969	18305	22000
Sundry Creditors (Trade)	4747	7144	7852	9863
Advance from customers	0	0	0	0
Dividend payable	1212	606	612	777
Other statutory liabilities (due within 1 year)	0	0	0	189
Term loan installments/DPGs/debentures	8617	12179	20520	3382
Provision for taxation	480	691	891	913
Other current liabilities and provisions	230	47	38	72
Interest accrued on loans	0	0	0	0
Unclaimed dividend	0	0	0	0
Provision for contingencies	0	0	0	0
	15286	20667	29913	15196
Total Liabilities and Equity	68218	73807	86628	105000

Exhibit 3 (Contd.)

ASSETS (Rs. in million)	2010-11 (Audited)	2011-12 (Audited)	2012-13 (Audited)	2013-14 (Projections)
Fixed Assets:				
Gross block	33507	30606	33814	45638
Less: Accumulated depreciation	5103	6288	7488	9214
Net block	28404	24318	26326	36424
Intangible assets	500	1149	1912	1509
Investments				
Investments in subsidiaries	1270	979	1168	3721
Current Assets				
Cash and Cash Equivalents				
Cash and bank balance	1069	777	824	659
FDs in banks	0	513	579	579
	1069	1290	1403	1238
Receivables				
Receivables (other than deferred and exports)	9875	9167	13280	13011
Export receivables	3208	6959	9041	9500
	13083	16126	22321	22511
Inventories				
Raw materials (imported)	2088	956	1513	2298
Raw materials (indigenous)	1726	2354	1876	4386
Stock-in-process	4946	5170	5556	6744
Finished goods	2551	2665	3317	4529
Other consumable spares	450	428	420	420
	11761	11573	12682	18377
Loans and Advances				
Advance to supplies of raw materials and stores spares	937	1096	2078	2200
Other current assets	6764	5704	5282	7740
Advance payment of income tax	0	778	243	800
Margin money	0	569	482	600
Deposits for premises with group	3700	4775	4775	4775
Deposits for premises with other parties	0	888	930	930
Advances to suppliers of capital goods	0	2027	1427	1150
Advances to sister concerns	0	698	1147	1045
Advances to others	0	161	80	80
Deposits for sales depots	0	0	0	0
Deferred receivables	0	0	2520	0
Other miscellaneous deposits	730	1676	1852	1900
	12131	18372	20816	21220
TOTAL ASSETS	68218	73807	86628	105000

Exhibit 4

LP Laboratories: Operating Income Statement (Rs. in millions)

Particulars	2010-11 (Audited)	2011-12 (Audited)	2012-13 (Audited)	2013-14 (Projections)
Gross Sales Local	36475	36732	38940	52042
Gross Sales Exports	15272	20024	23095	30000
Export Incentives	1076	1974	1685	2958
Total Sales	52823	58730	63720	85000
Excise Duty	3115	3789	4307	4923
Net Sales	49708	54941	59413	80077
Cost of Sales				
Raw Material				
Imported	12894	12430	17128	16710
Indigenous	17074	18611	15662	29278
Stores & Spares	332	393	522	621
Power and Fuel	1219	1634	1765	2165
Direct Labor	1588	1782	1930	2505
Repairs and Maintenance	0	561	488	0
Other Manufacturing Expenses	927	568	647	1845
Depreciation	1059	1113	1194	1726
Sub Total	35093	37092	39336	54850
Opening Stock-in-process	3093	4946	5170	5556
	38186	42038	44506	60406
Closing Stock-in-process	4946	5170	5556	6744
	33240	36868	38950	53662
Opening Finished Goods	2081	2551	2665	3317
	35321	39419	41615	56979
Closing Finished Goods	2551	2665	3317	4529
Cost of Production	32770	36754	38298	52450
Selling and General Administration Expenses	8951	11325	12174	14573
Cost of Sales	41721	48079	50472	67023
Operating Profit before Interest	7987	6862	8941	13054
Less: Interest	3812	4685	5017	7647
Operating Profit after Interest	4175	2177	3924	5407
Non-operating Income	110	400	231	0
Non-operating expenses	526	0	531	0
Net of Non-Operating Income	-416	400	-300	0
Profit before Tax	3759	2577	3624	5407
Provision for Tax	130	150	200	549
Profit after Tax	3629	2427	3424	4858

Source: Exhibits 3 and 4 are submitted by the company to the bank

Exhibit 5

LP Laboratories – Cash Flow Statement (Rs. in millions)

Particulars	2010-11 (Audited)	2011-12 (Audited)	2012-13 (Audited)
Net Profit before Tax	3759	2577	3624
Operating Profit before WC changes	9125	7870	10032
Adjustments for			
Trade and Other Receivables	-919	-7244	-3744
Inventories	-2473	187	-1108
Trade Payables	1311	2397	384
Cash Generated from Operations	1311	3210	5564
Interest Paid	7044	-4460	-4417
Direct Taxes (paid) Refund	-3852	1	-45
Deferred R&D/Development Expenses	243	-1033	-1447
Net Cash Flow from Operating Activities	3434	-2283	-346
Net Cash Flow from Investing Activities	714	-89	-2685
Proceeds from Issue of Share Capital	0	0	761
Unpaid Allotment Money Received	2	0	0
Increase in Borrowings	-2759	3801	3035
Dividend Paid	-1192	-1207	-607
Premium Paid on Debentures	19	0	0
Corporate Dividend Tax Paid	0	0	-61
State Subsidy	15	0	15
Net Cash from Financing Activities	-3953	2594	3144
Net Increase in Cash and Cash Equivalents	195	222	113
Cash and Cash Equivalents (beginning)	873	1069	1290
Cash and Cash Equivalents (ending)	1069	1290	1403

Source: The Annual Report of LPL

Exhibit 6

Outstanding Balance with other Branches for the Current Year ending March 31, 2013
(Rs. in millions)

Particulars	Amount of Drawing Power Transferred	Outstanding Balance (Debit)	Outstanding Balance (Credit)
Mumbai Main Office	5.00	0.00	19.70
Santa Cruz Branch	51.50	-31.48	0.00
Guwahati Branch	2.00	0.00	4.51
Patna	2.00	0.05	0.00
Johari Branch	0.50	0.00	7.99
Colony Branch-Bhopal	7.50	0.00	43.95
Mandi Branch - Bhopal	3.00	0.00	12.45
Industrial Estate - Ankaleshwar	10.00	0.00	7.55
Aurangabad	18.50	-15.30	0.00
Total	100.00	-46.73	96.15

Source: Bank records

Exhibit 7

Laboratories: Details of Installed Capacity and Utilization

Classification	Unit	Installed Capacity	Capacity Utilization
Tablets	Numbers in million	10745	812
Liquids	Kilo-Liters	3108	2142.2
Capsules	Numbers in million	186	2434
Injections - Liquids	Kilo-Liters	42	170.12
Injections - Vials	Numbers in million	12	.6
Creams and Powders	MT	403	0
Bulk Drugs and Intermediates	MT	1236	1033.01

Source: Information submitted by the company to the bank

Exhibit 8

Outstanding Loan Limits and Balance as on March 31, 2013

Exhibit-8: Outstanding Loan Limits and Balance as on 31st March 2013																
Facility	KBIL		Bank -1		Bank -2		Bank -3		Bank -4		Bank -5		Bank -6		TOTAL	
	Limit	Balance	Limit	Balance	Limit	Balance	Limit	Balance	Limit	Balance	Limit	Balance	Limit	Balance	Limit	Balance
Cash credit/Packing Credit	1135	1048	472	486	200	820	100	141	118	667	118	135	118	215	2261	3512
Working capital Demand Loan	4530	4631	1888	1888	800	800	400	400	472	472	472	472	472	494	9034	9157
Export Bills																
Purchased/Export Bills Discounted	2520	2495	1050	572	270	0	500	647	600	336	160	126	650	344	5750	4518
Advance against Bills	0	86	0	0	0	0	0	0	0	0	0	0	0	0	0	86
EBP/EBD LC	0	899	0	0	0	0	0	0	0	0	0	0	0	0	0	899
Rupee Loan	0	0	0	558	0	0	0	0	0	0	0	0	0	0	0	558
Total Fund Based	8185	9159	3410	3503	1270	1620	1000	1188	1190	1475	750	733	1240	1053	17045	18730
Int/Imp DP/DALC	3456	2404	1440	483	610	1	750	16	360	918	360	84	460	351	7436	4257
Letter of Guarantees	960	237	400	158	170	6	34	0	100	0	100	0	0	0	1764	401
Total Non-Fund Based	4416	2641	1840	641	780	7	784	16	460	918	460	84	460	351	9200	4659
Grand Total	12601	11800	5250	4144	2050	1627	1784	1204	1650	2393	1210	817	1700	1403	26245	23389

Source: Bank records

Annexure I	
Financial Instruments for Working Capital	
Cash Credit (CC)	<ul style="list-style-type: none"> • This is similar to overdraft; under this account, banks lend money against the security of inventories and receivables. • It runs similar to a current account (or savings account) except that the money that can be withdrawn from this account is not restricted to the amount deposited in the account. Instead, the account holder is permitted to withdraw a certain sum called "limit" or "credit facility" in excess of the amount deposited in the account. • Cash credits account in theory, payable on demand.
Working Capital Loan	<ul style="list-style-type: none"> • Loan is a straightforward vanilla product (also known as working capital demand loan, WCDL) with a fixed repayment schedule and pre-defined interest rate.
Rupee Pre-shipment Credit/Packing Credit (PC)	<ul style="list-style-type: none"> • Packing credit is a loan/cash credit facility sanctioned to an exporter at the pre-shipment stage. • The bank seeks a letter of credit opened in favor of the exporter from the overseas buyer along with the irrevocable (cannot be canceled once drawn) purchase order from the buyer favoring the exporter. • Packing credit facility will cover all the working capital needs of the exporter including raw materials, wages, packing costs, and all pre-shipment costs. • The period for which a packing credit advance may be given by a bank will depend upon various factors such as the time required for procuring, manufacturing or processing (where necessary) and shipping the relative goods/rendering of services. It is the banks to decide the period for which a packing credit advance may be given, with regard to the various relevant factors so that the period is sufficient to enable the exporter to ship the goods/render the services. • Banks may release the packing credit in one lump sum or in stages as per the requirement for executing the orders/LC. • Banks may also maintain different accounts at various stages of processing, manufacturing, etc. depending on the types of goods/services to be exported, for e.g., hypothecation, pledge, etc., accounts and may ensure that the outstanding balance in accounts is adjusted by transfer from one account to the other and finally by proceeds of relative export documents on purchase, discount, etc. • Banks should monitor the progress made by the exporters in timely fulfillment of export orders.

Bills Discounting	<ul style="list-style-type: none"> • Banks take the bills drawn by borrower on his/her (borrower's) customer and pay him/her immediately deducting some amount as discount/commission. The bank then presents the bill to the borrower's customer on the due date of the bill and collects the total amount. If the bill is delayed, the borrower or his customer pays the bank a pre-determined interest depending upon the terms of transaction. • The bill of exchange is a sight bill if the drawee is to make payment immediately on presentation of bill to him/her. • A bill is usance bill if the drawee is to make payment after a period.
Documents against Acceptance (D/A)	<ul style="list-style-type: none"> • A mode of payment where the bill of exchange and documents are sent to the importer's bank with instruction to release the documents to the importer/buyer only after the acceptance of the bill of exchange payable at a determinable future date. • The collecting banker has to deliver the documents to the drawee (buyer) on the acceptance of the bill by him/her. The payment will be made by the drawee on the due date of the bill. Date of acceptance to date of payment bank remains unsecured.
Documents against Payment (D/P)	<ul style="list-style-type: none"> • A mode of payment where the documents are sent directly to the importer's bank with instruction to release the documents to the importer/buyer only after payment has been made. • Documents will be delivered to the drawee only on payment until which time they are retained by the bank. So, the bank retains control over goods until payment is received. • The drawer has to instruct the bank whether the bill is DA or DP.
Export Bills Purchase and Discounting (EBPD)	<ul style="list-style-type: none"> • Advances granted to exporter based on complying shipping documents presented for negotiation. The bank pays in advance the value of documents prior to receipt of proceeds from the issuing/reimbursing bank. • Here export bills may not be covered under LC. • Full value of the bill is paid to the exporter and the bank is holder of the bill.
Export Bill for Collection (EBC)	<ul style="list-style-type: none"> • Export documents presented for negotiation are sent to issuing/collecting bank for collection. The exporter is only paid upon receipt of proceeds from the issuing/reimbursing/collecting bank. • Advance against bill for collection. Rupee advance and exchange risk remains with the customer. The bank is agent of the exporter.

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Foreign Currency Loan (FCL)	<ul style="list-style-type: none">• The foreign currency denominated loans in India is granted against the foreign currency funds the bank is having on account of FCNR (B) Deposit. These loans are commonly known as FCNR (B) Loans.• The interest rates are linked to LIBOR.
Bank Guarantee (BG)	<ul style="list-style-type: none">• Guarantees can be performance or financial based.• Performance guarantee: The seller issues a performance guarantee to ensure or give concrete commitment to the buyer through its bank. This method ensures the buyer the timely execution of an agreement to have the goods exported or delivered or services performed.• Financial guarantee: Financial guarantee is a bond which is not cancelable and ensures the payment of the interest and repayment of the principal amount as per the schedule agreed upon by both the borrower and the lender.
Bid bond	<ul style="list-style-type: none">• A bid bond is issued as part of a supply bidding process by the contractor to the project owner, to attempt to guarantee that the winning bidder will undertake the contract under the terms at which they bid.

Source: Master Circular - Rupee/Foreign Currency Export Credit and Customer Service to Exporters, Reserve Bank of India, July 1, 2015

Annexure II

Bills of Exchange and Bill Finance¹

A bill of exchange in India is defined in Section 5 of the Negotiable Instruments Act, 1881, as “an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument”. It may not be out of place to take note of a similar wording of the definition of bill of exchange (in Britain), which runs as “an unconditional order in writing addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand, or at a fixed or determinable future time, a sum certain in money to or to the order of a specified person, or to the bearer”.

A bill is usually drawn by the drawer (seller of the goods) that as per some pre-existing arrangement the bill will be paid by the person on whom the bill is drawn. At times, the payment may be directed to a third party who has acted as an agent.

The payee is the first holder; any subsequent transferee can become the holder such as an endorser or a bearer. It is mentioned in the Act that the capacity to incur liability on a bill is the same as the capacity to enter into an ordinary contract or in other words all persons of full age and who are *compos mentis* have the maximum power to draw or accept a bill.

Types of Bills of Exchange:

- a) On the basis of due for payment: In the instance of demand bill, payment is due immediately “at sight” or “on presentation”, while “usance” bill has a fixed maturity (usually 3 months)
- b) If the bills are accompanied by documents such as title to goods such as railway receipts/bills of lading, etc. called as documentary bills, otherwise they are called clean bills.
- c) “D/A” and “D/P” bills on the basis of whether the documents are deliverable just against acceptance (D/A) or deliverable only against payment (D/P) usually through a bank. A D/A bill becomes a clean bill immediately after the delivery of the documents.

Features of Bills

In a trading situation, for a credit sale transaction, a seller desires to be paid immediately after the sale of goods, while the buyer would like to gain time until the resale of goods. Here, the seller becomes the creditor and the buyer, the debtor. To overcome the delay in collection of money, the creditor draws the bill of exchange of given maturity of say 90 days on the debtor. With the acceptance of the bill, the seller becomes the drawer and the debtor the drawee. The bill, when accepted by the drawee through his/her endorsement, becomes a credit instrument which the drawer (seller) can exchange with his/her bank under a prior arrangement for ready money sanctioned by way of a credit limit. This ready money is lower than the face value of the bill and the difference constitutes the “discount” charged by the bank at a prescribed

¹ This section is largely dependent on Negotiable Instrument Act 1881, Circulars of RBI and Satyamurthy B (1994), Bill Financing in India: Policies, Problems and Prospects, *Prajnan*, 23(4),

rate per annum for the maturity period. The amount released is treated as an advance against the security of the accepted bill.

There can be broadly four types of procedures in dealing with the bills in trade finance:

- a) On the direct acceptance of the buyer himself/herself
- b) On the buyer's and his/her banker's co-acceptance
- c) On the letter of credit opened by the buyer with his/her bank in favor of seller and further his/her personal acceptance of the bill by the buyer
- d) Buyer's bank discounting the bill for the account of the buyer

Sequential steps followed in dealing with each of these procedures are as follows:

A. Trader's Bill:

- a. Seller supplies goods and submits bill to the buyer for the value of goods supplied.
- b. Buyer accepts the bill along with the goods supplied/
- c. Seller receives the accepted bill from the buyer and discounts the bill with seller's bank.
- d. Buyer makes the payment on due date.

B. Bills with Co-acceptance:

- a. Seller supplies goods and submits bill to the buyer for the value of goods supplied.
- b. Buyer accepts the bill along with the goods supplied.
- c. Buyer's bank co-accepts the bill.
- d. Seller receives the bill accepted by the buyer and the co-accepted by the buyer's bank and discounts with the seller's bank.

C. Bills Accompanied with Letter of Credit (LC):

- a. Seller supplies goods and submits bill to the buyer for the value of goods supplied.
- b. Buyer accepts the bill along with the goods supplied.
- c. Buyer's bank opens LC in favor of the seller.
- d. Seller receives the bill accepted bill along with the LC opened by the buyer's bank in favor of the seller and discounts with the seller's bank.

D. Drawee Bills:

- a. Seller supplies goods and submits bill to the buyer for the value of goods supplied.
- b. Buyer accepts the bill along with the goods supplied.
- c. Buyer's bank discounts the bill for the account of the buyer.

Stages in Bill Finance

The bank can, after duly verifying the requirements of the customer and satisfying itself with the genuineness of such requirements prescribe limits for acceptance of bills for purchase of the raw materials

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and sub-limits for each drawer as a pre-production credit limit. The bank can finance against stocks/receivables cash credit limits and bill finance against bills. The bank fixes purchasing limits and sub-limits for drawer as a post-production credit limit.

Issues in credit monitoring:

Bill transactions may lead to frauds and money laundering. Banks may check the following to arrest such frauds.

- a) Amounts of bills offered are higher than the average business turnover of the party.
- b) Over-invoicing of bills
- c) Frequent occasions of reversal of bills on the grounds of “payment not received”
- d) When bills are drawn on the same drawees for the same or equal or round amounts
- e) On or around the due date of the bill discounted by bank, the drawer submits fresh bills for similar amount.